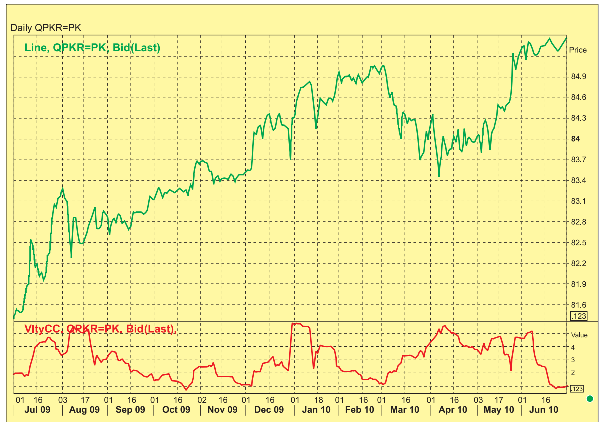
4 Exchange Rate and Reserve Management

4.1 Overview

Owing to the improvement in overall external balance, USD/PKR exchange rate has shown relative stability during FY10 compared to FY09. Pakistan's currency depreciated by 5 percent vis-à-vis US dollar during FY10 compared to a sharp decline of 19 percent last year. Overall, the exchange rate movement continued to reflect market conditions and facilitated adjustments to achieve a sustainable external balance and macroeconomic stability.

Figure 4.1: USD/PKR Exchange Rate Movement during FY 10



Source Reuters:

A number of factors contributed to the stability in the Foreign Exchange market. Amongst them, the shrinking current account deficit, realization of proceeds from IMF Stand By Arrangement, higher home remittances from overseas Pakistanis, and improved Foreign Exchange reserves were some of the key factors instrumental in keeping the exchange rate relatively stable during the year. Pakistan's current account deficit narrowed to its lowest in five years as exports increased and remittances surged to a record high. The deficit in the year ended June 30th narrowed to $3.51 billion from $9.26 billion a year earlier. Similarly, the volume of home remittances sent by overseas Pakistanis showed a significant rise of 14.01 percent to reach a record high volume of $8,905.95 million during the year. Foreign Exchange Reserves which were at $12,425 billion at the close of FY09, increased by $4,325 billion to reach a historic high of $16,750 at the close of FY10. In addition to these positive developments, SBP's pro-active market monitoring and timely measures to curb speculative tendencies also helped in the smooth functioning of the market. SBP's decision to enhance Foreign Exchange Exposure Limit of the banks also strengthened market's capacity to handle larger volumes of foreign exchange transactions without creating any excessive volatility in the exchange rate. Resultantly, during the period under review PKR showed healthy volatility in both directions based upon the prevailing demand and supply conditions in line with the SBP's policy of market based exchange rate determination.

Table 4.1: Percentage Change in PKR/USD Parity in FY10

Month end	Closing rate	Monthly change	Change since June 09
Jun-09	81.46		
Jul-09	83.24	2.20	2.20
Aug-09	83.02	-0.30	1.90
Sep-09	83.15	0.20	2.10
Oct-09	83.74	0.70	2.80
Nov-09	83.57	-0.20	2.60
Dec-09	84.24	0.80	3.40
Jan-10	85.07	1.00	4.40
Feb-10	85.07	0.00	4.40
Mar-10	84.09	-1.20	3.20
Apr-10	84.00	-0.10	3.10
May-10	85.38	1.60	4.80
Jun-10	85.51	0.10	5.00

Table 4.2: Exchange Rate Trend, Volatility and Change in percent

Year	High	Low	Close	Average	Volty C/C	Change
FY06	60.45	59.57	60.22	59.87	0.90	-1.00
FY07	61.01	60.18	60.37	60.65	1.00	-0.30
FY08	69.75	60.30	68.40	62.68	4.00	-13.30
FY09	84.08	68.47	81.46	78.65	6.70	-19.10
FY10	85.58	81.40	85.51	83.89	3.00	-5.00

Source: REUTERS

4.2 Withdrawal of SBP Support for Oil Payments

A significant development during FY10 was completion of the phased transfer of POL payments to the interbank market. Though this was a major step by the SBP, the transition was smoothly effected without any speculative pressure on the Exchange parity. Since 2004, SBP had been providing foreign exchange to banks against their clients' payments for POL imports. In Nov 2008, a phased program was announced to the market according to which SBP ceased to provide foreign exchange for oil payments from December 2009. Because of proactive market management by SBP, the transition was smoothly completed in Dec 2009. The move was not only istrumental in developing the Foreign Exchange market through increased trading volumes but also helped in reducing pressure on the country's Foreign Exchange reserves. During FY10 SBP provided only $2,111 million to the banks for POL support which was significantly less than the $9,233 million provided in FY09.

Table 4.3: POL Payments during FY09 - FY10
million US dollar

FY10				FY09			
Month	**SBP's share**	**Bank's share**	**Total**	**Month**	**SBP's share**	**Bank's share**	**Total**
9-Jul	667	173	840	8-Jul	1,141	105	1,246
9-Aug	260	517	776	8-Aug	1,498	0	1,498
9-Sep	364	637	1002	8-Sep	1,554	0	1,554
9-Oct	329	592	920	8-Oct	1,170	0	1,170
9-Nov	316	425	741	8-Nov	740	0	740
9-Dec	175	816	991	8-Dec	690	0	690
10-Jan	0	716	716	9-Jan	503	0	503
10-Feb	0	883	883	9-Feb	328	133	461
10-Mar	0	726	726	9-Mar	294	182	476
10-Apr	0	911	911	9-Apr	368	179	547
10-May	0	1,032	1032	9-May	366	167	533
10-Jun	0	1,173	1174	9-Jun	581	233	814
Total	2,111	8,601	10,712	Total	9,233	999	10,232

Table 4.4: Daily Arabian Light Crude Closing Prices
in US dollar, change in percent

ARL-OSP-A quote	Highest quote	Lowest quote	Average daily close	YoY change*
FY03	33.1	22.6	27.2	-
FY04	37.7	24.9	30.2	11.00
FY05	55	32.5	41.2	36.40
FY06	69.9	49.9	58.7	42.50
FY07	73.8	48.5	61.2	4.30
FY08	140.6	66.1	92.6	51.30
FY09	143.6	32.7	67.1	-27.50
FY10	87.63	60.85	74.7	11.30

Source: Reuters

*= YoY change in average close prices

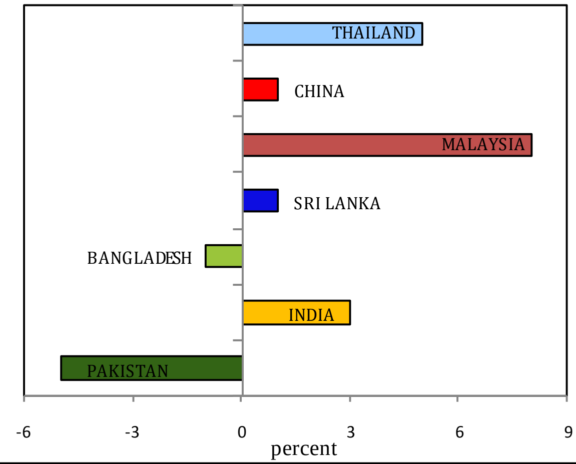
During FY10, although, the average daily price of crude oil remained slightly higher than FY 09, oil prices witnessed far more stability compared to the previous year. During the period under review, price of Arabian Light Crude Oil moved in the range of 60.85 and 87.63 compared to the low and high levels of 32.7 and 143.6 respectively in FY 09.

Regional Perspective

During FY10, most of the regional currencies witnessed appreciation vis-à-vis dollar. These included Malaysian ringgit, Th ai baht, Indian rupee, Chinese yuan, and Sri Lankan rupee. Amongst them, Malaysian ringgit gained the most strength, i.e., 7.7 percent appreciation against the US dollar. However, Pak rupee and Bangladesh taka were the exceptions in the region showing depreciation against US dollar.

4.3 Foreign Exchange Reserves Management

Figure 4.2: Currencies Performance Against US$ in FY10



During 2010 the global economy started its arduous recovery from the painful economic turmoil of 2008. Though the Western World was quick to come out of the recessionary phase, concerns quickly emerged over size of the global stimulus as well as fiscal indiscipline in the Euro zone. The lack of fiscal discipline in certain Euro zone countries created much anxiety in the financial markets and soon-after developed into a full blown sovereign debt crisis. With the introduction and implementation of fiscal austerity measures in Euro zone countries, a full global recovery is likely to remain hampered in the medium-term given Euro zone's strong financial integration with the US and Asian economies.

While global economic releases showed recovery and strengthening in H1 FY10 and H2 FY10 respectively, central banks in the wake of precarious macroeconomic conditions did not opt for quick policy normalization. And the near-zero interest rate policies were extended by most of the developed central banks till more robust and sustainable economic indicators are achieved. The timing and nature of exit strategies, both monetary and fiscal, will dominate policy debate and economic outlook, adding considerable uncertainty about the outlook even beyond 2010. On the brighter side, emerging markets performed relatively well despite weakness in Western World, providing further support to the view that emerging markets are increasingly becoming a source of global growth.

Pakistan's FX Reserves registered an increase of 35 percent ($ 4.3bn) to reach US$ 16.7 billion at the end of FY10. SBP's reserves increased by 42.1 percent ($3.8bn) to reach US$12.9 billion whereas commercial banks' reserves increased by 14.7 percent (US$485 million) during FY10. The increase can be attributed to a significant reduction in the current account deficit, strong remittances, and IMF support. Current account deficit slimmed to US$ 3.5 billion in FY10[1] from US$ 9.3 billion in FY09. Oil Import bill benefitted from subdued international oil prices which averaged around $80/barrel in FY10 as against approximately $90/barrel in FY09. In addition, record remittances of circa US$ 8.9 billion during the year also helped in maintaining a positive trend in reserve growth.

The fixed income returns profile is also likely to remain weak as the policy rates remain near zero and are expected to stay at current level in short to medium term. Equity markets although recovered from the decline in 2009, remained highly volatile and are still significantly below the peak levels of 2007. The gross return in FY10 on overall reserves remained above benchmark. SBP continues to allocate assets strategically taking into consideration the improving global economic situation, increasing size of reserves, and flow of funds to and from the economy

[1] Provisional Figures

through various channels including imports, exports, foreign investments, remittances as well as multinational programs.

To achieve the objective of enhancing in-house reserve management, capacity building measures were taken both at departmental and cluster level. Trainings opportunities were provided to staff in all areas of investments including fixed income portfolio management, reserve operations, and performance reporting. For this, different sources were utilized including web-based interactive trainings, teleconferencing seminars, and professional certifications. Currently, most of the personnel have already achieved a high level of financial competence or are in the process of developing advanced skills to better perform their roles.

4.3.1: Changes in Foreign Exchange Regime Taken Place during the Year 2009-10

Payment against Import of POL Products
The banks (ADs) are allowed with effect from December 14, 2009, to make all purchases of foreign exchange related to import of Crude Oil from the Interbank Market. Prior to this, banks were to make all purchases of foreign exchange from interbank market related to the import of POL products except that for Crude Oil.

Facility of 5 Percent Retention of Export Proceeds for Export of Cement
With a view to further liberalize the foreign exchange regime, cement exporters have been allowed to retain 5 percent of export proceeds against the cement exports in their Special FCY Accounts maintained with banks in Pakistan.

Special FCY Borrowing by Micro Finance Banks/ Institutions
To facilitate Micro Finance Banks/Institutions (MFB/Is), it has been decided to allow MFB/Is to raise foreign currency (FCY) loans from International Financial Institutions/Donor Agencies or Specialized banks/Institutions. While negotiating such borrowing, MFB/Is are required to ensure the terms and conditions embodied in the relevant circular.

Advance Payment against Import Letter of Credit
It has been decided to allow advance payments against letters of credit up to 100 percent of the FOB or CFR value of the imported goods subject to the terms and conditions embodied in the related circular. Previously, the said facility was available only to the extent of 25 percent of the FOB or CFR value of the goods to be imported.

Remittance of Freight Charges by Freight Forwarders/ Consolidators
To address the observations/difficulties raised by the concerned stakeholders, certain clauses of FE Circular No.06 of 2006 have been amended in line with the generally followed procedures while taking care of the interests of the exporters.

4.4 Home Remittances

Pakistan received historic high remittances of US$ 8.9 billion during FY10; a growth of 14 percent over the last year. This is attributed to the combined efforts of SBP and Pakistan Remittance Initiative (PRI).

4.4.1 Pakistan Remittance Initiative (PRI)

The State Bank of Pakistan, Ministry of Overseas Pakistanis, and Ministry of Finance launched a joint initiative called Pakistan Remittance Initiative (PRI). The objective of formation of PRI, a national body, was to facilitate and support faster, cheaper, convenient, and efficient flow of remittances. In the second phase, PRI is aimed to create investment opportunities in Pakistan for Overseas Pakistanis.

4.4.2 Analysis of Remittance System of Pakistan & PRI Strategy

At the outset of the drive, an analysis of the Home Remittance System was carried out with a view to collect and analyze remittance related data, identify the bottlenecks and weak links in the system, review the recent international efforts on remittances specially in the global and regional perspective, evaluate earlier schemes for the purpose, and compile practices followed by various jurisdictions to boost remittances. The analysis helped PRI to formulate a comprehensive strategy aimed at greater commitment of financial sector towards remittance services and resultant inculcation of remittance culture, transparency of remittance market with adequate consumer protection, efficiency of payment system infrastructure, and incentives for the remitters, beneficiaries, and overseas entities.

4.4.3 Implementation of PRI Strategy

Enhancing Outreach

PRI is encouraging banks in Pakistan to enhance their outreach worldwide through new remittance- specific related arrangements. Since the inception of PRI, more than 160 new arrangements for home remittances have been facilitated between banks and overseas entities.
Incentive for the Remitter and Beneficiary

To support overseas Pakistanis and their families back home, a reimbursement scheme has been implemented whereby GoP through State Bank of Pakistan reimburse 25 Saudi Riyals equivalent in PKR per transaction to the banks in Pakistan provided that, amongst others, the remitter and the beneficiary should not be charged any remittance fee. In turn, the banks share the reimbursed amount with the overseas entities as per their related agreements.

Incentive Scheme for Overseas Entities

One of the major impediments to the flow of remittances through formal channels has been insufficient marketing efforts at the originator end to provide information about the remittance channels and other facilities. To encourage overseas entities for making additional efforts, a performance based scheme has been introduced by PRI. As per the scheme, overseas entities shall be reimbursed marketing expenses at the end of the year based upon their performance and other related terms and conditions.

Improvements in Payment System Infrastructure

Reliable and efficient payment systems are vital to facilitate secured and efficient delivery of home remittances. This goal will be achieved through a phased implementation of payment system strategy with the help of State Bank of Pakistan. PRI facilitated banks to introduce cash over the counter (COC) payments of Home Remittances being a popular mode of collecting remittances in Pakistan. All major banks have already started COC payments for remittances.

In the first phase banks are also using PRISM (RTGS) to transfer and settle inter-bank transactions. This has enabled banks to transfer inter-bank transactions into beneficiaries' accounts on the same day. Participating banks have been encouraged to take the following initiatives:

To have a system to send SMS to the remitter and the beneficiary, after crediting the remittance amount in the beneficiary account or in the system for cash payment at the counter.

- Install ATMs at key locations/ branches to facilitate cash withdrawals after banking hours and on holidays. In this regard they may also take measures to create awareness among beneficiaries to use ATM for cash withdrawals.
- To promote use of E-Banking/M-Banking Channels to make payments at merchant sites, transfer of funds, pay utility bills, etc. after banking hours. In this regard, banks are being encouraged by PRI to issue Remittance Cards.

Participating banks have been further advised to ensure adequate controls in the process of transfer and payment of remittances in/through beneficiary's account and over-the-counter payments. Furthermore, they are also required to carry out procedures required to ensure strict compliance with all SBP rules & regulations including those related to KYC and AML/CFT measures.

Complaints Handling and Feedback Mechanism

To provide a reliable and immediate contact point, 24 hours, 7 days a week, a call centre has been established by PRI which is now operational. All overseas Pakistanis and their families can inquire about the remittance services of banks and lodge their complaints with the call centre. There are toll free numbers for overseas Pakistanis residing in various regions.

A comprehensive website has been established to provide complete information about the processes involved in the remittance transactions. Further, to facilitate remitters in identifying a nearby banking channel, a locator has been placed on website http://www.pri.gov.pk

Monetary Penalty on Delay in Remittance

To encourage Overseas Pakistanis and others to use banking channels for home remittances, and to protect the remitters / beneficiaries from any losses due to unwarranted delays in receipts of funds in the beneficiaries' accounts, a mechanism has been put in place. In case the amount of remittance is not credited/ paid to the beneficiary as per stipulated instructions, the beneficiary shall be entitled to a return of sixty five (65) paisa per thousand rupees per day from the concerned bank for the number of days credit/payment on account of remittance was delayed.

PRI-PIA Alliance

PRI-PIA alliance is aimed at a strategic long-term partnership for the purpose of catering to the needs of Pakistani citizens living overseas including the need of such Overseas Pakistanis to travel to and from Pakistan and to facilitate the flow of remittance from them. The two organizations will work in a phased manner. In ***phase 1*** PRI will announce a scheme for Overseas Pakistanis under which initially 100 free return air tickets will be given by PRI through lucky draw each month. The winner will be entitled to facilities like excess baggage allowance, access to special lounges, reception at arrival, etc. In ***phase 2*** both PRI and PIA will introduce a co-branded frequent flyer card and a miles program linked up with remittance transactions. The card holder will be entitled to a number of privileges such as free tickets, and excess baggage allowance.

Conclusion

At the moment, all PRI efforts are aimed at bringing structural changes in the Remittance System of the country with a long-term vision about these recurring flows. It is a daunting task to introduce changes in the decades old system and procedures with a strongly embedded particular mind-set of the stakeholders involved. The task becomes more difficult in wake of global recession, return of migrants, lack of financial literacy, perceptual barriers and volatility of exchange rates. Notwithstanding the impediments, PRI is geared up to achieve its objective of maximizing the flow of remittances through formal channels. It is pertinent to mention here that as per international reports, Pakistan has highest growth in remittances in the world based upon calendar year comparative performance.

4.5 Exchange Companies

During FY 10, SBP took the following measures related to the affairs of Exchange Companies:

Instructions Related to Retention of Record. To ensure availability and maintenance of data and record, it was advised that Exchange Companies must maintain all record of their business transactions including those related to remittances transactions (both inward and outward) for 10 years from the date of transaction or longer if so prescribed under other laws, rules, and regulations.

Instructions related to timely Provision of Record to any Law Enforcement Agency. Exchange Companies were advised that all information / record should be maintained in such a manner that the same may be made readily available to SBP or any other relevant law enforcement agency as and when required as per related laws. Further, any information / record requisitioned by any law enforcement agency during their investigation / prosecution process should be provided timely as per the governing laws.

Instructions related to Complete Information in Remittance Transactions. The Exchange Companies were advised to ensure, during remittance transactions, complete originator information available through the payment chain.